



THE CITY OF SAN DIEGO  
MAYOR JERRY SANDERS

M E M O R A N D U M

DATE: March 19, 2008

TO: Councilmember Donna Frye

FROM: Jay M. Goldstone, Chief Operating Officer  
Greg Levin, Comptroller

SUBJECT: Response to memo from Councilmember Donna Frye titled "*Internal Controls for DROP re: Federal and State Tax Reporting Withholding and Compliance*"

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This memorandum serves as the response to the attached memorandum from Councilmember Donna Frye entitled "*Internal Controls for DROP re: Federal and State Tax Reporting Withholding and Compliance*", dated December 18, 2007.

**Background:**

The memorandum from Councilmember Frye was addressed to numerous officials of the City of San Diego (CITY) and San Diego City Employee Retirement System (SDCERS), the independent auditor of the City and SDCERS, and the City's Independent Consultant who is currently responsible for reporting to the SEC in regards to the City's compliance activities. Councilmember Frye's memo referenced several legal documents provided by SDCERS (attached) and made various inquiries including issues related to financial reporting of the City and SDCERS as well as compliance with state laws and federal regulations.

We note that the memorandum was also addressed to the City Attorney, and therefore, we refer matters subject to the analysis of federal tax regulations and state law, as they relate to the City, to his office. We also note that Councilmember Frye's understanding of issues related to the Preservation of Benefit plan may be assisted by reviewing several active City Attorney Memoranda's of Law concerning the City's Preservation of Benefit Plan.

On January 10<sup>th</sup>, Mrs. Joanne SawyerKnoll replied to this memo (attached) indicating her request of Mr. David Wescoe, SDCERS Pension Administrator, to provide additional information. In response to Ms. Knoll's request, as well as to another request from Chief Operating Officer Mr. Jay M. Goldstone, SDCERS requested of their legal counsel, ICE Miller LLP (ICE Miller), to review the topics addressed in the memo. ICE Miller responded to Mr. Goldstone via a letter

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(attached). Accordingly, we will defer to the letter provided by ICE Miller for questions and issues related to SDCERS.

**Responses to the questions included in the memo are as follows:**

**QUESTIONS 1 – 3:**

Can a “global settlement” of the type SDCERS and the IRS seem to be contemplating (see attached document titled **SDCERS Contribution Schedule and Settlement Amounts, dated August 20, 2007**) be accomplished without resolving the Federal tax reporting and withholding compliance issues related to contributions to or distributions from SDCERS directly or indirectly put in place by SDCERS? Is the \$43 million proposed amount due from the City disclosed in the financial report? Has it been disclosed that this information has not been provided to the City Council by management and that management has not brought forward to the City Council for discussion any IRS proposed settlement?

**ANSWERS 1- 3:**

1. Questions related to a Global Settlement are answered on page two of the ICE Miller letter.
2. The recently completed City of San Diego Comprehensive Annual Financial Report for the fiscal year 2005 includes the following passage:

A comprehensive settlement was reached between the IRS and SDCERS on December 20, 2007 (Settlement). The Settlement requires the City and SCDERS to take certain corrective actions regarding certain provisions of its retirement plan within 150 days of December 20, 2007. **The Settlement does not require the City to pay any penalty payments or to make any additional contributions to the retirement system.** In the event the City does not successfully implement certain plan document changes required by the IRS Compliance Statement, SDCERS and the City may face additional regulatory actions from the IRS including but not limited to, SDCERS plan disqualification and financial penalties against the City, the plan sponsor.

3. No. However, we note that the information referenced was the work product of legal counsel retained by SDCERS. Legal matters are typically handled in closed session and not discussed publicly in order to protect the Taxpayers from assuming potential liability.

**QUESTIONS 4 - 8:**

When distributions from the City's tax qualified plans (whether the DROP, 401a, 401k, SPSPs, etc.) are made to beneficiaries:

- Does the City or SDCERS report the distribution to the applicable taxing agencies?
- Does the City or SDCERS withhold Federal and State income tax in a manner that complies with federal and state law?
- Which entity is responsible for reporting the distribution – the City or SDCERS?
- Which entity is responsible for withholding Federal and State income tax – the City or SDCERS?
- What can be done to eliminate any risk to the City from compliance failures?

**ANSWERS 4-8:**

4. The question is answered on Page 3 of the ICE Miller letter.
5. To the best of our knowledge and belief except for the items addressed in the Internal Revenue Service Compliance Statement, the City's procedures for calculating and reporting tax withholdings and deferred compensation arrangements (including municipal code provisions) comply with the Federal Tax Regulations and State law. For City payroll, taxes are withheld and remitted to the proper agency. City Payroll withholdings for various retirement plans and state and federal taxes are reported on each employees pay check remittance and annually on a form W-2. The City is subject to periodic audits from the Internal Revenue Service, the last of which occurred during fiscal year 1996. These audits often result in findings; however, do not generally result in any risk of material financial penalty to the City. The City is currently in the process of replacing its legacy payroll system and will review the process for generating payroll during the next year.

The ICE Miller letter generally addresses this question as it relates to SDCERS on page 2 in response to Question 1 of Councilmember Frye's Memorandum.

6. Responsibility for reporting distributions from the City's 401K and SPSP plans is assigned to the plan administrator which is currently Wachovia Corporation. The City also maintains a 457 plan which is administered and reported by AIG insurance group.
7. See Answer #5.
8. Compliance Federal Regulations and State Tax Laws is complex. The City could establish a retainer for a Tax Consultant to provide advice and guidance on the City's process for withholding federal and state taxes, record retention, and other matters related to Internal Revenue Service Regulations and State Law.

**QUESTIONS 9 – 10:**

If a beneficiary moves to a state other than California and receives a distribution from a DROP account:

- Is that distribution subject to income taxes in California or in the State in which the beneficiary now resides?
- Does the City/or SDCERS report the transaction to the State of California or the State in which the beneficiary now resides?

**ANSWERS 9 -10:**

9. This is a legal question to which we refer to the City Attorney.
10. Reporting of distributions from DROP accounts are the responsibility of SDCERS. The ICE Miller Letter addresses this in part on Page 3 by stating that distributions are reported on a 1099R which ostensibly are provided to the beneficiary; however, the letter does not directly indicate to whom or when they provide this information to.

**QUESTIONS 11 – 16**

- Has the City/or SDCERS been *reporting* to the appropriate State and Federal income tax authorities any of the SDCERS' distributions, including:
  - DROP distributions rolled over into Traditional or Roth Individual Retirement Accounts?
  - DROP distributions that are withdrawals where the money goes directly to the employee/retiree instead of being rolled over into an IRA?
  - Past Corbett distributions?
  - Pension checks sent directly to the retired employee?
  - The amount of the monthly pension deposited into the employee's DROP account?
  - If not, are any of these distributions exempt from reporting? Is it the responsibility of the City or SDCERS to report these distributions? Who is responsible/liable for non-reporting?

**ANSWERS 11 – 16**

11. This question is answered on page 3 of the ICE Miller letter.
12. This question is answered on page 3 of the ICE Miller letter.
13. This question is answered on page 3 of the ICE Miller letter.
14. This question is answered on page 3 of the ICE Miller letter.
15. Reporting on additions to individual DROP accounts, if necessary, is the responsibility of SDCERS. This question is not clearly addressed in the ICE Miller letter.
16. These questions are generally answered on page 3 of the ICE Miller letter; however the third part of the question would likely require an interpretation of law. As such, we encourage you to refer to the City Attorney for a formal analysis.

Generally, our understanding is that as sponsors of plans administered by SDCERS, the

City, Port Authority, and Airport Authority generally bear some indirect risk as a result of plan expenses and liabilities that are required to be funded by Plan Sponsors. Specific liabilities and expenses would be directly passed to the Plan Sponsors or funded over several years of contributions depending on the specific circumstances of each situation as they may arise.

#### QUESTIONS 17-22

- Has the City/or SDCERS been *withholding* Federal and State income tax for distributions including but not limited to:
  - DROP distributions - whether as a lump-sum or a partial rollover into a Traditional or Roth Individual Retirement Account (IRA)?
  - DROP withdrawals where the money goes directly to the employee/retiree instead of being rolled over into an IRA?
  - Past Corbett distributions?
  - Pension checks sent directly to the retired employee?
  - Pension checks (or funds equivalent to the monthly pension) deposited into the employee's DROP account?
  - If not, are any of these distributions exempt from federal and state withholding requirements? If not exempt, is it the City's or SDCERS' responsibility to withhold these taxes?

#### ANSWERS 17 – 22

17. In substance, this question appears to be the same as Question #11. As such, please refer to Answer #11.
18. In substance, this question appears to be the same as Question #12. As such, please refer to Answer #12.
19. In substance, this question appears the same as Question #13. As such, please refer to Answer #13.
20. In substance, this question appears the same as Question #14. As such, please refer to Answer #14.
21. In substance, this question appears the same as Question #15. As such, please refer to Answer #15.
22. In substance, this question appears the same as Question #16. As such, please refer to Answer #16.

#### QUESTIONS 23 – 31:

Has the City/or SDCERS been *reporting* to the Federal and State(s) income tax authorities any contributions being made into the various tax qualified retirement accounts (such as the 401a, 401k, SPSPs, and DROP "account") including:

- Pre-tax contributions made by employees to the 401k;
- Pre-tax contributions made by employees to the SPSP plans;
- The pre-tax contributions made by the City into the SPSP plans;
- Contributions in the form of pre-tax pension checks (or funds equivalent to the monthly pension) deposited into the DROP "account";
- The 3.05% pre-tax contributions from the employee salary into the DROP account;
- The 3.05% pre-tax "matching" contributions from the City as plan sponsor into the DROP accounts;
- The 2% COLA annual increase – pre-tax into the DROP accounts;
- The 8% annual interest credited to the DROP account – pre-tax;
- If not, are any of these contributions exempt from reporting? If not exempt, whose responsibility is it to report all of these contributions – the City or SDCERS?

#### ANSWERS 23 – 31

- 23. 401k Contributions are pre-tax and are reported on the employees form W-2.
- 24. SPSP Employee Contributions are post tax and reported on the employees form W-2.
- 25. This question is answered on Page 5 of the ICE Miller letter.
- 26. This question is generally addressed on page 3 of the ICE Miller letter.
- 27. Yes.
- 28. This question is answered on Page 5 of the ICE Miller letter.
- 29. See Answer #15.
- 30. See Answer #15.
- 31. This question is generally addressed on page 5 of the ICE Miller letter.

**QUESTIONS 32 – 37:**

Does the City/or SDCERS allow employees or retirees to rollover money from an IRA or a 401k *into* their DROP accounts?

- If so, has the City/or SDCERS then allowed that same money to be distributed from the DROP accounts tax-free?
- Does the City/or SDCERS keep track of those pre-tax contributions from IRAs or 401ks that are rolled into the DROP accounts?
- If so, how? I ask because the Ice Miller Report states on page 26 that “*SDCERS staff has indicated that the SDCERS system does not track employer contributions as to what portion represents an offset contribution and what portion represents a pick-up (as Code Section 414(h)(2) defines the term) contribution.*” While I realize that these contributions are of a different nature, if SDCERS is not keeping track of them, perhaps SDCERS is not keeping track of other contributions as well.
- Are there any Federal or State income tax law requirements for the City and/or SDCERS to report the employer “pre-tax” pickup contribution?
- Whose responsibility is it to report this – the City’s or SDCERS’?

**ANSWERS 32 – 37:**

- 32. This question is generally addressed on page 5 of the ICE Miller letter.
- 33. Assuming that this question is dependent on the response to Question #32, this matter is not applicable.
- 34. Assuming that this question is dependent on the response to Question #32, this matter is not applicable.
- 35. Assuming that this question is dependent on the response to Question #32, this matter is not applicable.
- 36. This question is generally addressed on page 5 of the ICE Miller letter.
- 37. Assuming that this question is dependent on the response to Question #32, this matter is not applicable.

**QUESTIONS 38 – 40:**

When firefighters convert annual leave or other non-monetary benefits into “virtual” dollars which are then used to purchase years of service (or extend the DROP program beyond five years) at an agreed price, is there a 1099 issued? Is that an event exempt from reporting? Whose responsibility is it to report this – the City or SDCERS?

**ANSWERS 38 – 40:**

- 38. ICE Miller Letter responds to this question in a general manner on page 5.

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39. See Answer #38.

40. See Answer #38.

**QUESTIONS 41-42:**

If the City of San Diego is allowed to:

- Not withhold or report federal and state income taxes;
- Not issue 1099s on distributions from tax qualified plans such as the DROP program and/or the 401a, and;
- Allow more money to be contributed into tax qualified plans than is allowed under IRC Section 415 – both on an after-tax and pre-tax basis;
- Are these types of contributions and distributions from non-municipal tax qualified plans legal in the private sector? Or is this just a special plan for the municipal agencies?

**ANSWERS 41 – 42:**

41. It is not clear from your question whether the questions are dependent on an answer to the 1<sup>st</sup> sentence. However, we note that these questions concern legal interpretations and analysis of complex tax regulation that would be typically performed by the Office of the City Attorney as it relates to the City.
42. See Answer #41.

**QUESTION 43:**

Does the City/or SDCERS have any knowledge of a lack of compliance with State or Federal tax and reporting laws?

**ANSWER 43:**

43. See Answer #5.



## QUESTIONS 44 - 54

Who (at the City or SDCERS) is working "to test for both the dollar and compensation limits under Code Section 415(c)"?

- How is this currently being tested at the City?
- Does the City or SDCERS advise employees on an annual basis what the maximum limits are that may be contributed to all of these tax qualified plans (401a, 401k, SPSPs, etc.) in aggregate?
- Is the City currently in compliance with all the relevant Federal and State tax laws?
- What is the potential financial liability to the City for lack of compliance?
- Is this issue disclosed in the 2005 CAFR? If so, where?

Page 35 also states that "...SDCERS must select a definition of compensation..."

- Does the City have the responsibility to review and approve the "definition of compensation" selected by SDCERS?
- Does the City have a responsibility to select its own definition of compensation?

Page 35 also states that "*The pre-tax (picked-up) contributions to SDCERS would not be used in the 415(c) testing.*"

- Why not?
- Is Ice Miller suggesting the City should be testing the pre-tax (picked-up) contributions under 415(c)?

Page 26 of the Ice Miller report notes that "...the SDCERS system does not track employer contributions as to what portion represents an offset contribution and what portion represents a pick-up (as Code Section 414(h)(2) defines the term) contribution."

- So how then can this be tested?

## ANSWERS 44 – 54:

44. SDCERS is the lead agency and testing was performed by their actuary, Cheiron Inc.
45. See Answer #44.
46. Administration of the POB plan is the responsibility of SDCERS. In this regard, SDCERS has stated in a Press Release dated February 6, 2008 that individuals affected by 415(b) limits will be contacted.
47. See Answer #5.
48. In the event that a compliance failure is identified, numerous remedies are available to the IRS. This is a question of legal tax compliance and the Counsel should refer to the City Attorney or Outside Counsel for additional information.
49. SDCERS participation in the IRS Voluntary Compliance program is disclosed on pages 19, 20, 145 and 146 of the City's fiscal year 2005 CAFR.
50. This is a legal question and should be referred to the City Attorney or Outside Counsel. However, in the course of ratifying the IRS Compliance Statement, the City's Chief Operating Officer met with the IRS and reviewed the plan compliance statement, related findings, and the Compliance Strategy.
51. See Answer #50.

- 52. This question should be referred to ICE Miller, the firm that created the Compliance Strategy for an explanation of this statement since it is not clearly addressed in the ICE Miller letter.
- 53. See Answer #52.
- 54. See Answer #52.

#### QUESTIONS 55 - 64

There is no discussion of the fact that the City has not filed for a Private Letter Ruling on DROP. Doesn't this and the issues above need to be disclosed in light of the growing enormity of this program?

Page 3 of the Macias Gini letter also states that "*The DROP participant makes reduced retirement contributions to SDCERS...*"

It was my understanding that once an employee went into DROP they were retired and no longer made contributions to SDCERS. Is this correct?

- Are these "pre-tax contributions" in compliance with Federal and State laws?
- Does Macias Gini have a responsibility to investigate and disclose this?
- What is the potential liability to the City if this is not OK with the IRS?

Page 3 of the Macias Gini letter also states that "*DROP obligations have been shown as liabilities of SDCERS in the City's financial statements.*"

- What are the specific DROP "obligations" to the City?
- Is that reflected on the City's financial statements? Where?
- What about the Federal and State withholding requirements? Are those reflected in the City's financial statements?
- Is the 8% interest credited to the DROP accounts that reflected as a liability for the City in its financial statements?
- Is the 2 % annual COLA increase on the DROP accounts reflected in the City's financial statements?

#### ANSWERS 55 - 64

55. Currently, Municipal Code § 24.1404(c)4 States:

*"An amount equal to 3.05% of the Member's Base Compensation, credited bi-weekly at the end of each pay period. This amount will be deducted from the Member's salary on a pre-tax basis pursuant to Internal Revenue Code section 414(h)(2)."*

- 56. This is not a correct understanding. Your conclusion is most likely derived from a misunderstanding of Municipal Code §24.1402(b)4 which states that a member stops accruing benefits under other provisions of Article 4: City Employee's Retirement System (emphasis added).
- 57. These contributions are Pre-Tax.
- 58. Macias, Gini and O'Connell (Macias) have not been engaged to "investigate" DROP and disclosures are the responsibility of City Management. In the context of their Audit Plan,

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it is presumed that Macias has planned accordingly to satisfy themselves as to the propriety of the City's Contingent Liability (legal and regulatory claims incurred or incurred but not yet received) estimates, accruals and disclosures which are provided by the City Attorney, along with the City's estimates for accrued wages and benefits.

59. This would be a contingent liability estimate which is the responsibility of the City Attorney.
60. DROP Obligations would be the cumulative value of the nominal accounts for all DROP participants. It is disclosed on Page 63 under the classification "DROP Liabilities", for the fiscal year ended 2005, this amount was approximately \$ 228,511,000.
61. See Answer #60.
62. The extent to which the City retains unpaid withholdings due to the State or the U.S. Treasury at the end of a fiscal year is shown as a component of the liabilities reported under the classification "Accrued Wages and Benefits" on the City's Statement of Net Assets.
63. Yes, this is shown as part of the liability discussed in Answer #60.
64. Yes, this is shown as part of the liability discussed in Answer #60.

Attachments:

1. Memorandum from Councilmember Donna Frye
2. Legal Documentation Provided by SDCERS
3. Memorandum from Joanne SawyerKnoll
4. Letter from ICE Miller

EC: Mayor Jerry Sanders  
City Council  
City Attorney  
Mary Lewis, CFO

# SDCERS CONTRIBUTION SCHEDULE AND SETTLEMENT AMOUNTS

ARC is for Fiscal Year	Valuation Report Date	Prepared By	ARC Amount	Payment Dates	Amount Paid to Date	Amounts Due from City per IRS (Amounts Due Established Per IRS Settlement)	Amount Paid Over the ARC Since 7/12/05
7/1/2005 to 6/30/2006 Extra City Contribution Received	6/30/2004	GRS	\$156.0 M	7/1/2005 6/22/2006	\$163.0 M \$100.0 M	(Note: Initial IRS filing made 7/12/05. Additional filings proposing additional City contributions made 4/19/06, 5/9/06, 6/7/06, 6/13/06, 6/19/06, and 6/22/06.) *	
Extra City Contribution Received		(Note: Cheiron replicated numbers)		6/29/2006	\$8,298,430	401 (b) for First Period: \$31,618,356  Retiree Health Administrative Expenses: \$2,211,895  10% Disability Overpayment: \$1,221,543	\$108,298,430**
7/1/2006 to 6/30/2007 Extra City Contribution Received	6/30/2005	Cheiron	\$162.0 M	7/1/2006 6/29/07	\$162.0 M \$6.2 M	(Note: IRS filing on 415 made 8/6/06) ***  415 Excess Benefits: \$8,160,027	\$7,008,977
Extra City Contribution Received				6/30/07	\$808,977		
7/1/2007 to 6/30/2008 Extra City Contribution Received	6/30/2006	Cheiron	\$137.7 M	7/2/2007 7/2/2007	\$137.7 M \$27,334,773		\$27,334,773
<b>GRAND TOTALS</b>			<b>\$455,700,000</b>		<b>\$605,342,180</b>	<b>\$43,211,821</b>	<b>\$142,642,180</b>

\* Settlement amounts in this group calculated as of June 30, 2006. Includes interest at 8% to June 30, 2006.  
 \*\* Did not include difference between \$163 and \$156 M since paid 7/1/05 prior to first filing with IRS on 7/12/05.  
 \*\*\* Settlement amounts calculated as of June 30, 2007. Includes interest at 8% to June 30, 2007.

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August 20, 2007